

Using Hedge Funds for Portfolio Diversification

Hedge funds aren't for everyone, but they can be a strategic addition to the portfolios of some qualified investors. Why?

The returns of traditional investments like stocks and bonds are generally highly dependent on market direction. By contrast, many hedge funds attempt to achieve positive returns that are largely independent of the direction of major market indices. Historically, the hedge fund asset class has not moved in tandem with more traditional investment asset classes.

In the worst 10 quarters for global equity markets since 1990, hedge funds (as measured by the HFRI Fund of Funds Composite Index) outperformed a long-only investment in the MSCI World Index in all cases. This illustrates two of the primary reasons why sophisticated investors choose to allocate a portion of their well-diversified portfolio to hedge funds: the ability to preserve value in down markets, and low correlation to traditional stocks and bonds.

HOW DO HEDGE FUNDS WORK?

Hedge funds generally use strategies that do not rely on a rising stock or bond market for their primary source of return. Some of the more common hedge fund strategies are listed below.

- Arbitrage strategies attempt to profit from the perceived mispricing of two related securities. This strategy involves purchasing a security believed to be undervalued, shorting a related security that is perceived to be fairly valued or overvalued, and waiting for the prices to move towards each other.

- Long/Short Equity strategies attempt to profit from the stock picking skill of the hedge fund manager. Offsetting long and short stock positions are used in an effort to reduce exposure to some market related risks.
- Global Macro strategies attempt to profit from global macroeconomic analysis by detecting mispriced securities in global markets.
- Event Driven strategies attempt to profit from special opportunities such as mergers or acquisitions.
- Managed Futures strategies seek to profit from price trends in the global futures and forward markets.

THE RISKS OF HEDGE FUNDS

While the performance of hedge funds was compared to traditional investments, it is important to understand that hedge funds are unique investments with certain risks that traditional investments do not share. Hedge funds:

- Often engage in leveraging and other speculative investment practices that may increase the risk of investment loss;
- Can be highly illiquid;
- Are not required to provide periodic pricing or valuation information to investors;
- May involve complex tax structures and delays in distributing important tax information;

* HFRI Fund Weighted Composite Index represents an equally weighted index of more than 1,400 hedge funds. The HFRI Fund Weighted Composite Index is not based upon a complete representation of the hedge fund industry. Fund performance outside the coverage of the index will vary significantly.

** The Lehman Brothers Aggregate Bond Index represents a diversified portfolio of fixed income securities, including U.S. Treasuries, investment-grade corporate bonds, and mortgage-backed and asset-backed securities.



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- Are not subject to the same regulatory requirements as mutual funds, and hence, may not provide as much disclosure;
- Often charge high fees.

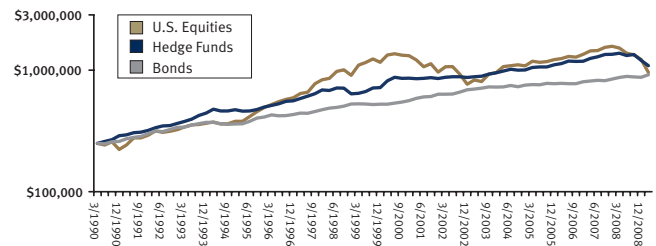
Please review the section “Certain Risks of Hedge Funds” for more information.

DIVERSIFICATION WITH HEDGE FUNDS

Used carefully in a well-balanced portfolio, hedge funds may add important diversification benefits. The following graph is a risk versus return chart that shows the effect of adding a 10% hedge fund allocation to portfolios with varying mixes of bonds and stocks. The chart uses standard deviation of return as a measure of risk, which considers how returns are spread around their average. The higher the standard deviation, the greater the chance that an investor would not have achieved the average return in any given year.

The bottom line represents portfolios consisting of varying percentages of bonds and stocks. The top line represents similar portfolios with a 10% hedge fund asset class allocation. A typical investor would want to achieve the highest level of return for a given level of risk, and correspondingly would want to take on the lowest amount of risk for a given target of return. For the time period January 1, 1990 to December 31, 2005, the portfolios with a hedge fund allocation generally experienced lower risk (standard deviation of returns) for a given target return because the hedge funds returns sometimes offset those of bonds and stocks, hence cushioning the total return the investor experienced.

Growth of \$250,000*



Allocating a portion of your portfolio to a hedge fund (or a mutual fund or exchange traded fund that behaves like a hedge fund) may reduce the overall volatility of your portfolio and create the potential for greater wealth creation and preservation over time.

Source: Zephyr Associates

Analysis period: 1/1/1990 – 12/1/2008. Representative benchmarks used: Equities – S&P 500 Index, Hedge Funds – HFRI FOF Composite Index, Bonds – Barclays Capital Aggregate Bond Index. See appendix for benchmark definitions.

INTRODUCING FUND OF HEDGE FUNDS

Spreading risk among a variety of hedge fund strategies and managers may be an effective way to attempt to further reduce risk and achieve more consistent returns for the portion of your portfolio in this asset class. Some hedge fund strategies perform better than others under certain market conditions. Fund of hedge funds provide a vehicle for investing in multiple hedge fund strategies and managers.

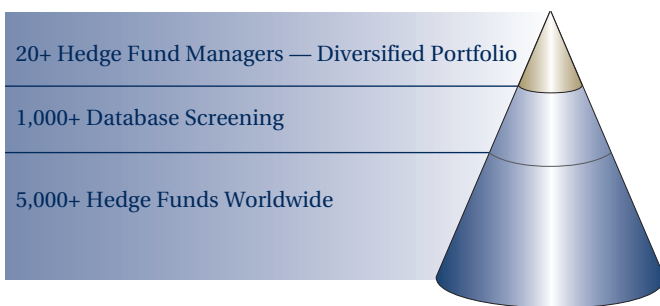
A POWERFUL RESOURCE

Because there is little public information available on hedge funds, investors often turn to fund of hedge funds managers with specialized expertise and resources in hedge funds. Fund of hedge funds managers seek to build key relationships with hedge fund managers, fund administrators, prime brokers, and other professionals knowledgeable about the hedge fund industry. Many fund of hedge funds managers work to leverage these relationships to gain valuable insights and access to industry veterans and information.

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In addition, fund of hedge fund managers may also provide the following services:

- Establish the allocation of the various hedge fund strategies and styles to meet the fund of hedge funds investment objectives.
- Implement a rigorous manager selection process that includes both quantitative and qualitative aspects. There are now more than 8,000 hedge funds according to Hedge Fund Research, Inc. Screening this number down to a more manageable universe and then conducting due diligence requires resources and many years of practical experience. It is common to see a combination of 20 or more different hedge fund managers included in a diversified fund of hedge funds, each with a unique approach to investing.
- Apply a well-disciplined, methodical approach to monitoring investments. This includes resources dedicated to ongoing reviews as well as periodic on-site visits with the managers.



INCORPORATING HEDGE FUNDS INTO YOUR PORTFOLIO — INVESTMENT CONSIDERATIONS

To determine if investing in hedge funds is right for you, and, if so, to create an appropriate asset allocation to hedge funds, you must consider several different factors including:

- Your overall financial objectives
- The size and allocation of your portfolio
- Your risk profile
- Your investment time horizon

Your Financial Advisor can work with you to determine if investing in hedge funds is appropriate for you and, if so, a suitable allocation.

CERTAIN RISKS OF HEDGE FUNDS

Hedge funds are investments that carry substantial risks. For these reasons, they are only appropriate for sophisticated, experienced, high net worth investors. Many of the specific risks inherent in hedge fund investing are defined below.

LEVERAGE

Hedge funds often engage in leveraging and other speculative investment practices, which may increase the risk of investment loss. The value of an interest in a hedge fund may be subject to great risk from a minor change in market conditions or trends. Loss of all or substantially all of a hedge fund investment is possible.

LIMITED LIQUIDITY

Hedge funds offer limited liquidity. There is typically no secondary market for an interest in a hedge fund. Fund redemptions are typically permitted on a quarterly basis, but may be even more limited in accordance with the terms of the prospectus or other governing agreement. Investors should review the offering documents with your legal and or tax advisor and ask your Financial Advisor for clarification about the terms of the underlying investment if you are unsure.

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MANAGEMENT CONTROL

Investors have no ability to influence the management of a specific hedge fund or fund of hedge funds.

TAX IMPLICATIONS

Hedge funds may involve complex tax structures and delays in distributing important tax information.

Consequently, delays in reporting of tax information can affect an individual investor's ability to timely file tax returns. You may wish to speak to your tax advisor about the potential effect of such delays.

DIFFERENT REGULATORY REQUIREMENTS

Hedge funds are not subject to the same regulatory requirements or oversight as mutual funds. Specifically, many hedge funds are not registered as investment companies and are offered through unregistered private placements. Consequently, these investments are not subject to the same regulation, net capital or reporting standards as registered investment companies (like mutual funds).

POTENTIAL FOR FRAUD

There have been a number of high profile instances where hedge fund managers have violated investment guidelines, mispriced portfolios, and have engaged in fraudulent activities. The absence of external regulation of this product increases the risks of these types of events occurring.

HIGHER FEES AND EXPENSES

Hedge fund and fund of hedge funds often charge high fees and may be subject to high internal operating expenses relative to more traditional investments. These fees can include provision for the fund manager or sub-managers to receive a significant percentage (20% can be typical) of net profits generated by the fund. Please read the offering document carefully and speak to your Financial Advisor about any questions you have about the fees associated with any hedge fund or fund of hedge funds investment.

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